FILE COPY

FILED

OCT 19 1936

CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM 1936.

No. 74.

AMERICAN TELEPHONE & TELEGRAPH COMPANY, *et al.*,
Appellants,

against

UNITED STATES OF AMERICA, FEDERAL COMMUNICATIONS COMMISSION, *et al.*,
Respondents.

BRIEF FOR ADDITIONAL APPELLANTS.

ALLEN T. KLOTS,
Solicitor for Additional Appellants.

HAYDEN N. SMITH,
G. SCHUYLER TARBELL, JR.,
Of Counsel.

INDEX.

	PAGE
OPINION BELOW	1
JURISDICTION	1
QUESTIONS PRESENTED	2
STATEMENT	3
SPECIFICATION OF ERRORS	9
SUMMARY OF ARGUMENT	10

ARGUMENT.

I. The original cost provisions are void because they are capricious, arbitrary, unfair and misleading.. 11

II. The order is invalid because it has not provided any depreciable classification for certain items of tangible property clearly subject to depreciation.. 20

III. The provisions of the order and system complained of are not severable and the order and system as a whole should be annulled and set aside and the enforcement thereof enjoined 25

CITATIONS.

CASES: PAGE

Chesepeake & Ohio Ry. Co. v. *U. S.*, 5 Fed. Supp. 7, 10 11

Havre de Grace and Perryville Bridge Company v. *Towers*, 132 Md. 16, 103 Atl. 319, 321 (Md. 1918).. 25

Kansas City Southern Railway Co. v. *U. S.*, 231 U. S. 423, 440 11
Knoxville v. *Knoxville Water Company*, 212 U. S. 1.. 14
Knoxville v. *Knoxville Water Co.*, 212 U. S. 1, 13-14.. 23

Lehigh Valley R. R. Co. v. *U. S.*, 243 U. S. 412..... 23

Matter of New York Edison Company v. *Maltbie*, 244 App. Div. 685, at page 687 (aff'd 271 N. Y. 103).. 24
Matter of New York Edison Company, et al. v. *Maltbie*, 271 N. Y. 103..... 8

Norfolk & Western Railway Co. v. *U. S.*, 287 U. S. 134, 143 11

Passaic Consolidated Water Co. v. *Board of Public Utility Commissioners*, 5 N. J. M. 1078, 139 Atl. 324; aff'd 104 N. J. L. 666, 141 Atl. 921 (N. J. 1927).... 24
People ex rel. Iroquois Gas Corporation v. *Public Service Commission*, 264 N. Y. 17..... 15
People ex rel. New York Railway Company v. *Public Service Commission*, 223 N. Y. 373..... 24
Procter and Gamble Company v. *U. S.*, 225 U. S. 282.. 23

Southwestern Telephone Co. v. *Public Service Commission*, 262 U. S. 276, 289 25

United Railways v. *West*, 280 U. S. 234, 253 23

Yu Cong Eng v. *Trinidad*, 271 U. S. 500..... 11

TEXTBOOK: PAGE

Scharfman, The Interstate Commerce Commission Vol. II, pages 406-417 23

STATUTES:

Code of Laws of the United States, Title 28, Sec. 45a 4
Judicial Code Sections 212, 213 as amended.... 4
Communications Act of 1934, Sec. 220 ..... 5, 20
Act of June 19, 1934, Chap. 652, 48 Stat. 1078, 47 U. S. C. § 220 5

MISCELLANEOUS:

Order Michigan Public Utilities Commission dated Dec. 3, 1935, No. D-1140 8
Order Public Service Commission of Wisconsin dated Dec. 20, 1935, No. 2-U-902 8
Report Interstate Commerce Commission decided July 9, 1934, No. 25705 8

IN THE

SUPREME COURT OF THE UNITED STATES,

OCTOBER TERM 1936

No. 74.

AMERICAN TELEPHONE & TELEGRAPH COMPANY, *et al.*,
Appellants,
against
UNITED STATES OF AMERICA, FEDERAL COMMUNICATIONS COMMISSION, *et al.*,
Respondents.

BRIEF FOR ADDITIONAL APPELLANTS.

Opinion Below.

The opinion of the District Court (R. 561) is reported in 14 Fed. Supp. 121.

Jurisdiction.

This is an appeal from the final decree of a specially constituted District Court for the Southern District of New York. The decree was entered March 24, 1936 (R. 584). The petition for appeal was filed and allowed April 6, 1936 (R. 586-596). Additional appellants have complied with paragraph 1 of Rule 12 by filing a statement of the grounds on which the jurisdiction of this Court is invoked.

Questions Presented.

The main question presented is the validity of the Order of the Federal Communications Commission issued June 19, 1935 entitled "Telephone Division Order No. 7-C" prescribing a Uniform System of Accounts for telephone companies to take effect January 1, 1936 and in particular certain provisions thereof. We contend that certain provisions of this Order and the System prescribed thereby are so arbitrary and unreasonable as to be invalid, beyond any power conferred by statute upon the Commission, and deny the right to keep a true set of accounts in violation of the Fifth Amendment to the Constitution of the United States, and furthermore that these certain provisions are not severable from the system as a whole and invalidate the system as a whole.

In particular the provisions which are assailed are the so-called "original cost" provisions because:

1. They require that the difference between the amount paid for telephone property acquired by the accounting company from a prior owner and the cost to the original owner be treated wholly differently from the balance of the cost and be placed in an "Acquisition Adjustment" account to be disposed of, written off or provision made for the amortization thereof in such manner as the Commission may direct.

2. They fail to provide for or permit any charges for depreciation on the items placed in said Acquisition Adjustment account.

These provisions are to be found in the Uniform System of Accounts prescribed by the Order as follows:

Paragraph 100.1
Paragraph 100.2
Paragraph 100.3

Paragraph 100.4 (R. 122-124)
Instructions 80 and 82 (R. 118-120)
Instructions 20 and 21 (R. 107, 108)
Instructions 3.S.1 (R. 101)

A further question presented is the validity of instructions contained in said Uniform System of Accounts 2(b)(1) requiring that all outlay for plant and operating expenses shall be reasonable and any payments in excess of reasonable amounts shall be charged against income. This is coupled with a statutory provision that punishes as a criminal offense any failure to keep the accounts as prescribed.

The other provision objected to is that which excludes from Account 100.3, covering "Property Held for Future Telephone Use," property not held for "imminent" use, and requires it to be placed in Account 103, "Miscellaneous Physical Property," the depreciation, taxes and maintenance charges on which are not allowed in computing net operating income.

We contend that if the word "imminent" has its usual meaning, i. e., "immediate," the regulation is void, as arbitrary, and if it has not that meaning, it is so vague as to be no guide to accountants and no rule, the disposition of each item of property held for future use being subject to the discretionary dictation of the Commission, and that such treatment is outside of the authority given by the statute, which is to prescribe a uniform system of accounts.

Statement.

The parties on whose behalf this brief is submitted and who are herein sometimes referred to as "additional appellants" are the following telephone companies:

Ohio Associated Telephone Company
Indiana Associated Telephone Corporation
Michigan Associated Telephone Company
Southwestern Associated Telephone Company

Interstate Telephone Company
Tri-State Associated Telephone Corporation
Pennsylvania Telephone Corporation

These seven companies are all independent of the appellant American Telephone & Telegraph Company and the so-called "Bell System". They intervened in this proceeding pursuant to the provisions of the Code of Laws of the United States, Title 28, Section 45a, Judicial Code Sections 212, 213 as amended, and an order of the United States District Court for the Southern District of New York, dated December 6, 1935 (R. 221, 237).

This suit was instituted to enjoin the enforcement of an order of the Federal Communications Commission issued June 19, 1935 entitled "Telephone Division Order No. 7-C" prescribing a Uniform System of Accounts for telephone companies to take effect January 1, 1936 (R. 85-220). The suit was originally commenced by the American Telephone & Telegraph Company and twenty-six other telephone companies in the Bell System. Numerous other companies, including these seven additional appellants, shortly thereafter filed bills of complaint and intervened in the suit. The case was heard before a specially constituted District Court on a motion of the plaintiffs for a temporary restraining order and an interlocutory injunction (R. 306). At the conclusion of the hearing the parties stipulated to submit the case for final decree as well as for a temporary restraining order and interlocutory injunction upon the pleadings and affidavits (R. 552). The decision of the District Court was handed down on February 18, 936 (R. 561) and the decree entered March 24, 1936 (R. 584). The District Court permanently enjoined the enforcement of two provisions of the Commission's Order, but refused to enjoin certain other provisions of which the plaintiffs complained and the invalidity of which it was also claimed invalidated the entire Order.

The provisions of the Communications Act of 1934, Act of June 19, 1934, Ch. 652, 48 Stat. 1078, 47 U. S. C. § 220, which gave the Commission power to prescribe forms of account are as follows:

> "Sec. 220(a). The Commission may, in its discretion, *prescribe the forms* of any and all accounts, records, and memoranda to be kept by carriers subject to this Act, including the accounts, records, and memoranda of the movement of traffic, as well as of the receipts and expenditures of moneys.
>
> (b) The Commission shall, as soon as practicable, prescribe for such carriers the classes of property for which depreciation charges may be properly included under operating expenses, and the percentages of depreciation which shall be charged with respect to each of such classes of property, classifying the carriers as it may deem proper for this purpose. The Commission may, when it deems necessary, modify the classes and percentages so prescribed. Such carriers shall not, after the Commission has prescribed the classes of property for which depreciation charges may be included, charge to operating expenses any depreciation charges on classes of property other than those prescribed by the Commission, or, after the Commission has prescribed percentages of depreciation, charge with respect to any class of property a percentage of depreciation other than that prescribed therefor by the Commission. * * *
>
> (d) In case of failure or refusal on the part of any such carrier to keep such accounts, records, and memoranda on the books and in the manner prescribed by the Commission * * * such carrier shall forfeit to the United States the sum of $500.00 for each day of the continuance of each such offense.
>
> * * * * *
>
> (g) After the Commission has prescribed the forms and manner of keeping of accounts, records, and memoranda to be kept by any person as herein provided, it shall be unlawful for such person to keep any other accounts, records, or memoranda than those so prescribed or such as may be approved by

> the Commission or to keep the accounts in any other manner than that prescribed or approved by the Commission. Notice of alterations by the Commission in the required manner or form of keeping accounts shall be given to such persons by the Commission at least six months before the same are to take effect." (Italics ours.)

The provisions of the Uniform System prescribed by the Commission to which the argument in this brief will be primarily directed are the so-called "original cost" provisions. These provisions require that the plant investment accounts of a telephone company shall be divided into four main accounts as follows:

Account 100.1	Telephone Plant in Service
Account 100.2	Telephone Plant under Construction
Account 100.3	Property Held for Future Use
Account 100.4	Telephone Plant Acquisition Adjustment (R. 122, 123).

They then provide that in the *first three* of these accounts shall be entered only the so-called "original cost" of the property in question. "Original cost" is defined by Instruction 3.S.1. in said System as

> "The actual money cost of (or the current money value of any consideration other than money exchanged for) property at the time when it was first dedicated to the public use, whether by the accounting company or by a predecessor public utility." (R. 101.)

In other words, it is provided that into *these three* accounts there shall be entered in the case of property which has been purchased by the accounting company not the cost to the accounting company of such property, but the cost to the party which first dedicated it to the public use. Depreciation is allowed on depreciable items entered in these three accounts and they are in other respects treated by the System as normal plant accounts.

The balance of the actual cost to the accounting company of purchased telephone plant is ordered to be entered in Account 100.4 as "Telephone Plant Acquisition Adjustment". This account is treated quite differently from the normal plant accounts. It is provided in paragraph (C) of said Account 100.4 (R. 124) that

> "The amounts recorded in this account in respect to each property acquisition shall be disposed of, written off, or provision shall be made for the amortization thereof in such manner as this Commission may direct."

There is no rule or principle prescribed for disposing of the items in this Account No. 100.4.

It will then be discovered by examining paragraph 82, "Classes of Depreciable Telephone Plant" (R. 120) and paragraph 80 (R. 118) that no depreciation is permitted to be charged on the items contained in this account.

These "original cost" provisions apply not only to property hereafter acquired, but are retroactive in the sense that appellants are required to set up their books on this new plan even in respect to properties heretofore acquired. This makes the Order and System prescribed peculiarly burdensome upon these additional appellants because of the nature of their properties. These properties were practically all acquired from predecessor owners (R. 583). There were at least 233 of such predecessors (R. 583). In most instances additional appellants' immediate predecessors had in turn acquired these properties from former owners. These properties are located for the most part in small rural communities. Only two of the approximately 669 communities served have more than one telephone exchange (R. 459). The former owners who originally built the telephone lines consisted of small companies or individuals and in many cases farmers mutual associations. The records of the additional appellants' immediate predecessors were in almost every case inadequately and inaccurately kept and were themselves in turn based upon purchases of going businesses

from their predecessors. In many instances no records at all were kept by the companies, individuals or farmers mutual associations who originally built the telephone lines and plant and in many other cases their books or records are not now available, or if available are known to be inaccurate (R. 459-460, 462-467, 583).

"Original cost" provisions of a similar character adopted by the New York Public Service Commission have been held invalid under the laws and Constitutions of the State of New York and of the United States of America by the New York Court of Appeals in *Matter of New York Edison Company, et al.* v. *Maltbie,* 271 N. Y. 103. See also opinion of the Appellate Division of the Supreme Court, 244 N. Y. App. Div. 685.

The provisions herein assailed were urged upon the Interstate Commerce Commission by certain state commissions led by the Public Service Commission of New York (R. 15, 17). In July, 1934, the Interstate Commerce Commission rendered a report upon these various recommendations after numerous hearings at which representatives of the commissions and other companies appeared (R. 15). This report did not take the form of an order because the jurisdiction of the Interstate Commerce Commission in the matter was subsequently superseded by that of the Federal Communications Commission (R. 84). The Interstate Commerce Commission definitely rejected the proposal for such "original cost" provisions (R. 57, 83).

The Michigan Public Utilities Commission has rejected this very System by an order No. D-1140 dated December 3, 1935, effective January 1, 1936.

The Public Service Commission of Wisconsin by order No. 2-U-902 dated December 20, 1935 has rejected the treatment accorded to Telephone Plant Acquisition Adjustment Account, No. 100.4, and required that items in this account which consist of a portion of the cost of depreciable property be depreciated and appropriate depreciation reserve accounts set up.

Specification of Errors.

1. The District Court erred in refusing to enjoin the provisions of the Commission's Order respecting "original cost", particularly in so far as it requires the difference between the amount paid for property by the accounting company and the cost to some prior owner to be entered in the "Acquisition Adjustment" Account to be disposed of, written off or provision made for the amortization thereof in such manner as the Commission may direct (Assignments of Error, Nos. 1, 2, 3, 4, 5, 6, 7, 8 and 9, R. 587-589).

2. The District Court erred in refusing to enjoin the provisions of the Commission's Order respecting "original cost" in that they failed to provide for or permit charges for depreciation on the items placed in "Telephone Plant Acquisition Adjustment" Account (Assignments of Error, Nos. 4, 5, 6, 26, 28, R. 589, 592).

3. The District Court erred in refusing to enjoin the enforcement of Instruction 2(b)(1) respecting just and reasonable outlay for property or expenses (Assignments of Error, Nos. 10, 11, 12, 13, 14, 34, R. 590, 593).

4. The District Court erred in refusing to enjoin the enforcement of the provisions for classification of physical property, including particularly the classification based on "imminent" use, and the requirement that property not held for "imminent" future use should be placed in Account 103, Miscellaneous Physical Property (Assignments 14-18, R. 590-1).

5. The District Court erred in refusing to enjoin the enforcement of the whole Order, on the ground that the invalid provisions above mentioned and those it held void are inseparable from the rest and what remains is an incomplete and unworkable system of accounts (Assignments of Error, Nos. 20, 21, 22, 35, R. 591-593).

This brief will be devoted primarily to the argument of certain aspects of our "original cost" contentions. We endorse in addition the arguments made by the other appellants on the same point. We do not abandon the other errors hereinabove specified, but endorse the contentions of the other appellants in regard thereto and will refrain from burdening the Court with a repetition thereof.

Summary of Argument.

1. The right to keep a reasonable and adequate set of books is one which is recognized and protected by the courts and a denial of this right constitutes forthwith and immediately irreparable injury to these appellants. The "original cost" provisions violate this right of these appellants because they prescribe a system of accounts which is capricious, arbitrary, unfair and misleading. They require the segregation of a portion of the actual cost of acquired property into an account separate from the legitimate property accounts and characterize it as subject to treatment which has no basis either in fact or in the power of the Commission.

2. The statute requires the Commission to prescribe the classes of depreciable property. It is obviously intended that accounts shall be provided for each depreciable item on the company's books. Instead of doing this it has required depreciable items to be placed in Account 100.4—a non-depreciable account—and has provided no depreciable account for such items.

ARGUMENT.

I.

The original cost provisions are void because they are capricious, arbitrary, unfair and misleading.

A.

The right to keep a reasonable and adequate set of books is one which is recognized and protected by the courts.

Yu Cong Eng v. *Trinidad*, 271 U. S. 500;
Norfolk & Western Railway Co. v. *U. S.*, 287 U. S. 134, 143;
Kansas City Southern Railway Co. v. *U. S.*, 231 U. S. 423, 440;
Chesepeake & Ohio Ry. Co. v. *U. S.*, 5 Fed. Supp. 7, 10.

To deny by arbitrary and unreasonable requirements this right so indispensable to the proper conduct of any business, constitutes *forthwith* and *immediately* an injury to the appellants and requires no further action or fruition to make the damage complete.

B.

The "original cost" provisions prescribed by this Order are arbitrary and unreasonable not only because they are capricious but because in addition they result in false and misleading accounts. The fundamental vice of the system is that it segregates part of the actual cost to the accounting company of tangible telephone property into a separate account, to wit: Telephone Plant Acquisition Adjustment Account, No. 100.4, which is not accorded the treatment that a legitimate property account is entitled to. This segre-

gation and separate treatment is justified by nothing inherent in the items which are required to be put into this account. It is based on the wholly unfounded theory of the Commission that only the "original cost" is the figure to be included in the legitimate property accounts of the company.

The Telephone Plant Acquisition Adjustment Account is in its essence a suspense account, the items of which are subject to be disposed of, written off or amortized as the Commission may direct. Now there is no fact implicit in the genesis of the items which are to be placed in this account which makes them appropriate or qualified for any such classification. The items that go into this account go into it merely because they happen to be the difference between what the accounting company paid for the property and the so-called "original cost". This is their only determinant, but this fact is no criterion of whether they are to be written off or that they are to be amortized rather than depreciated, or, indeed, that they should be disposed of in any way different from the balance of the cost to the accounting company which goes into Accounts 100.1, 100.2 and 100.3. To require this classification and segregation of part of the actual cost for no reason whatever is thus capricious in the highest degree. It represents not only arbitrary action, but arbitrary action without any basis that is even colorably sound.

But more important, it is unfair, misleading and false. The implication is at once given that the items in Telephone Plant Acquisition Adjustment Account, 100.4, represents something intangible or unjustifiable write ups; that they are not entitled to have set up the usual depreciation reserve to which tangible assets in service are entitled and that they are subject to be written off out of surplus and the company required to take a loss in respect to them if the Commission so directs. The impression thus created by the requirement of this account, upon investors, security holders, ratepayers,

regulatory bodies or any other persons having occasion to examine the balance sheet of the company is false because:

1. The items in this account do represent actual assets devoted to the public use. Until there has been an adjudication in some sort of a proceeding such as a rate proceeding after a hearing on the specific issue that some part of the cost to these plaintiffs of property purchased represents excessive valuation, the amount actually paid by these plaintiffs for the property cannot thus be summarily impeached as representing a doubtful portion of the value of the asset. In most cases, as previously stated, the purchase of the asset at this price was approved by a state public service commission (R. 462-465). Certainly the price thus paid is a better criterion of the value of the property than a so-called "original cost" resurrected partly from incomplete and inaccurate records of the past and partly from pure estimate and conjecture. In the case of these particular appellants, for example, the original cost of the following portions of their entire properties will have to be estimated to the following extent:

Interstate Telephone Company.....	80%	R. 463
Michigan Associated Telephone Company	80%	R. 464
Ohio Associated Telephone Company...	75%	R. 465
Pennsylvania Telephone Corporation...	54%	R. 466
Tri-State Associated Telephone Corporation	50%	R. 466
Southwestern Associated Telephone Company	substantially more than half	R. 467
Indiana Associated Telephone Company..	substantial portion	R. 462

2. The implication that the items in this account are not entitled to be depreciated or to a depreciation reserve is also false. The Commission has not the power to deny to the company the right to set aside a depreciation reserve for these items, arbitrarily and solely on the basis that they happened to constitute an excess over the cost to the original owner.

In the case of *Knoxville* v. *Knoxville Water Company*, 212 U. S. 1, at page 13, the Supreme Court said:

> "It (the company) is entitled to see that from earnings the value of the property invested is kept unimpaired, so that at the end of any given term of years the original investment remains as it was at the beginning. It is not only the right of the company to make such a provision, but it is its duty to its bond and stock holders, and, in the case of a public service corporation at least, its plain duty to the public."

There is certainly no case in the books which holds that the investment which is to be kept unimpaired is the investment *of somebody else* rather than the investment of the accounting company.

By providing in this order that these items are non-depreciable, the Commission has assumed to prejudge them without a hearing as non-recoverable to any extent out of earnings, to set them apart with a stigma upon them, and thus without justification in fact or in law to cast doubt upon plaintiffs' whole property account.

3. The implication that these items are subject to be disposed of, written off or amortized as the Commission may direct is false and misleading. The term "written-off" as used in this provision was primarily intended to mean written off out of surplus, that is to say, taken as a loss and destroyed as an asset of the company. It is quite evident from the Order and System as a whole that this is the intended disposition of most of this account and anyone reading the Order and System prescribed would so assume. This implication is false and misleading because the Commission has no power to require these appellants to write off and take as a loss a part of what they actually paid for their property. There is nothing in the statute authorizing them to do this. The Commission's right to

determine a rate base does not either directly or by implication give it the power thus to deal with the company's investment. Certainly under the guise of prescribing a uniform system of accounts and as incidental thereto, the Commission has no right to require these plaintiffs to take a loss or to record on their books a loss which they have not actually suffered.

People ex rel. Iroquois Gas Corporation v. *Public Service Commission,* 264 N. Y. 17.

The New York Court of Appeals held and said in that case as to the power of the New York Public Service Commission, at page 21:

> "The power vested in the Commission to prescribe uniform methods of keeping accounts and records (Pub. Serv. Law, section 66, subd. 4), does not include the power to compel a corporation to write off from its book value a loss which it has not sustained, or to give up a part of its constitutional rights. If, as has been said, 'the actual cost of the property—the investment the owners have made—is a relevant fact' (Los Angeles Gas and Elec. Corp. v. Railroad Comm., 289 U. S. 287, 306) a corporation cannot be compelled to make entries upon its books calculated to conceal such relevant fact. It follows that the commission had no power to impose such condition."

The Commission's rate making power and its power to deny appellants the right to keep adequate and accurate accounts must, throughout this case, be carefully distinguished. We are not considering in this case the power of the Commission in determining rates to direct that a certain portion of the cost be disregarded. We are discussing the right of the Commission under the guise of prescribing "forms of account" to require these companies to write off from their books a loss which they have in fact not suffered. The Commission has no such power and a balance sheet

which labels a substantial part of the assets as subject to the exercise of such power is, therefore, false, inaccurate and misleading.

C.

If we assume for the sake of argument a balance sheet set up in the manner required by the Commission, we see the falsity in which it immediately results and the arbitrary and capricious nature of the order requiring such a balance sheet. Suppose Company XYZ acquired practically all of its telephone plant from predecessor companies and paid $1,000,000. for it. The balance sheet required by the Commission's Order would look something like this:

Assets		*Liabilities*	
Telephone Plant in Service (Acct. 100.1)	$ 700,000.00	Capital Stock...	$ 400,000.00
Telephone Plant Under Construction (Acct. 100.2)	50,000.00	Bonds	600,000.00
Property Held for Future Use (Acct. 100.3)	50,000.00	Other liabilities.	100,000.00
*Telephone Plant Acquisition Adjustment (Acct. 100.4)	200,000.00	Surplus (See Notes 1 and 2)	100,000.00
Other assets	200,000.00		
	$1,200,000.00		$1,200,000.00

*Note 1: Not subject to depreciation.

*Note 2: Subject to be disposed of, written off or provision made for the amortization thereof in such manner as the Commission may direct.

Looking at the above balance sheet it will appear that part of the actual cost of $1,000,000. to the XYZ Company of its plant in service has been removed from the physical plant accounts and put in the account labeled "Telephone Plant Acquisition Adjustment". There is no evidence either in the record or before the Commission that the portion of the cost represented by the $200,000. item is not just as much a legitimate part of the actual value of that property *for all purposes* as the $800,000. in the three preceding accounts. It being the price actually paid and there being

no presumption that the purchase was not one freely negotiated at arm's length, it is certainly important evidence of value at that time. In addition, in most instances it has been approved by some state commission (R. 462-465). There is no evidence that it represents improper write-up, water or any other inflated element of value. Certainly *prima facie* it is a much more reliable criterion of value than would be the guess as to what it may have cost a group of farmers mutual associations, which had no books and never had any books, which built the lines originally. Yet the only thing we are permitted to set up in our books and label as actual telephone plant in service or under construction or held for future use *is this estimate or guess.* The balance of the actual cost to us, namely the $200,000., we are required to submit to the stigma of this label.

Although the figures in the above example are fictitious and chosen solely for the sake of illustration, the notes indicated by an asterisk are by no means supposititious or imaginary. Honest accounting would seem clearly to require them. Thus Dean Madden of New York University in his affidavit says:

> "A balance sheet which would fail to call specific attention on its face to the fact that the Commission *must* extinguish this item and *may* extinguish it immediately by a write off is incomplete and misleading, and not in accordance with correct accounting principles." (R. 320).

The mere title of the account, "Telephone Plant Acquisition Adjustment" in itself casts a cloud of suspicion on the items and removes them from the category of tangible assets. When in addition these items are labeled as non-depreciable their impending doom as tangible assets is at once implied. Finally when they are labeled as subject to be written off or otherwise disposed of as the Commission may direct, the implication that their doom is sealed is irresistible. *And yet all these implications are false because*

they have no basis either in fact or in the power of the Commission!

In estimating the harm that results *immediately* and *forthwith* to the appellants, their stockholders and bondholders, by requiring the adoption of such misleading and false accounts and balance sheets, it is also to be remembered that investors in their securities invested on the faith of the balance sheets and accounts heretofore issued and kept by these companies in accordance with the requirements of the Interstate Commerce Commission, which show the true facts as to the actual cost to these appellants of the properties purchased and truthfully include this item in such cost. By merely looking at the sample balance sheet above set out, the disastrous result to the company's surplus of the segregation and earmarking as dubious of a part of the assets, heretofore legitimately carried as property of real substance, can at once be seen as well as the effect upon the value of its capital stock and even on its first mortgage bonds. This result is entirely unwarranted by any facts on which this harmful segregation is predicated. To impose a requirement which achieves such an unwarranted, false and misleading result is totally arbitrary and unreasonable.

D.

A comparison of Account 100.4 with Account 278 in the System now in effect prescribed by the Interstate Commerce Commission brings into sharp relief the wholly capricious nature of Account 100.4, as prescribed by this Order. The respondents have argued that Account 100.4 is of the same nature and performs the same functions as Account 278 and the Court below indicated this in its opinion (R. 567). The fact is, however, that the genesis of the items which go into Account 278 has a reasonable and proper relation to the function of this account, whereas the genesis of the items which go into Account 100.4 has no such relationship in fact or in law. Account 278 is arrived at under the System now in effect as follows:

When a going telephone property is acquired, so much of the purchase price as equals the current cost new of the various items of tangible property, except land, is carried in appropriate depreciable asset accounts. Land is carried in a separate account at estimated current value. The original cost of franchises is set up in another appropriate asset account. The balance, which will thus in real measure represent the amount in fact paid for the intangible or going value of the properties purchased, is placed in Account 278 (R. 404). Because of the intangible nature of the property thus put into Account 278 it is properly not subject to a depreciation charge. In other words; the determination of the items which go into Account 278 has a logical basis founded in law and fact in that property items properly non-depreciable are segregated into a non-depreciable account.

Account 100.4, as defined in the System complained of, however, has no such logical basis for separate classification, but on the contrary involves a wholly arbitrary and artificial segregation of part of the actual amount paid by the accounting party for each item of tangible depreciable property purchased. The difference between what the accounting party paid for the property and the original cost does not represent the amount paid for the intangible non-depreciable portion, if any, of the property purchased and is no measure thereof. To say that the excess paid over the cost to somebody else in the past is *ipso facto* or even *prima facie* paid for intangible good will or "going concern" value and is non-depreciable, disregards changes in true value due to changes in price level or other factors and has no foundation in logic or fact.

II.

The order is invalid because it has not provided any depreciable classification for certain items of tangible property clearly subject to depreciation.

By subdivision (b) of that Section of the Act which authorizes uniform accounts (Section 220), the Commission is required to prescribe the classes of property for which depreciation charges may be properly included under operating expenses. This provision of the statute reads as follows:

> "(b) The Commission shall, as soon as practicable, prescribe for such carriers the classes of property for which depreciation charges may be properly included under operating expenses, and the percentages of depreciation which shall be charged with respect to each of such classes of property, classifying the carriers as it may deem proper for this purpose. The Commission may, when it deems necessary, modify the classes and percentages so prescribed. Such carriers shall not, after the Commission has prescribed the classes of property for which depreciation charges may be included, charge to operating expenses any depreciation charges on classes of property other than those prescribed by the Commission, or, after the Commission has prescribed percentages of depreciation, charge with respect to any class of property a percentage of depreciation other than that prescribed therefor by the Commission. No such carrier shall in any case include in any form under its operating or other expenses any depreciation or other charge or expenditure included elsewhere as a depreciation charge or otherwise under its operating or other expenses."

In requiring the Commission to prescribe "the classes of property for which depreciation charges may be properly included under operating expenses" the statute undoubtedly

intended that the Commission should provide depreciable property accounts for *all* items representing depreciable property. The Commission has assumed to do this and in paragraph 82 of the Instructions has listed them (R. 120). On no other account or classification of property is depreciation permitted to be taken either as a charge to operating expenses or to any other accounts. No part of the items recorded in Account 100.4, however, is included in any of the depreciable accounts listed in paragraph 82 of the Instructions. These accounts are all sub-accounts of "Telephone Plant in Service" account, No. 100.1, into which is permitted to be entered only the "original cost" (R. 122).

Yet many of the items required to be placed in Account 100.4 are most certainly entitled to depreciation. As has already been indicated in the previous point, there is nothing in the genesis of the items in Account 100.4 which makes any of them non-depreciable. On the contrary, they represent a substantial portion of the cost of tangible depreciable property to the accounting company. *Prima facie* they are entitled to depreciation chargeable against operating expenses. Yet no depreciable account has been provided into which any of them may be put.

In failing to classify the items in Account 100.4 or any part thereof as depreciable the Commission has, therefore, omitted a substantial classification or classifications in its list of depreciable accounts. This Order which assumes to prescribe the complete set of depreciable accounts as directed by the statute, has thus omitted certain accounts which the Commission was directed by the statute to include therein. It is, therefore, vitally defective and invalid.

But the Commission argues that it still may permit appellants to depreciate some of the items required to be placed in Account 100.4 if requested individually item by item. The first answer to this is that the Commission has already assumed to name the classes of depreciable property and has excluded all items in Account 100.4 from these classes. No mention is made in the Order or any indication given that

any part of Account 100.4 is to be regarded as depreciable. Nor is any account provided into which these items could be put if ultimately so held. This Order was made, moreover, after numerous hearings, first before the Interstate Commerce Commission and then before this defendant Commission and when the Order was finally made no depreciable classification was provided for the items in Account 100.4. Appellants have a right under the statute to a depreciable classification for depreciable items and not merely a right to be afforded the opportunity to ask the Commission item by item that depreciation be permitted. The Commission's power in turn is limited by the statute to prescribing classifications.

Under the Commission's argument it could have placed the entire cost of acquired property in Account 100.4 and placed none of it in the depreciable plant accounts. Would this have been a justifiable classification? Would it have been an answer to the failure to provide a depreciable account for any part of the cost of acquired property that the company could have gone and asked them item by item to permit depreciation on such items? Or suppose the Commission had provided that all red telephone poles should be put in depreciable account 100.1 but that all green telephone poles should be put in account 100.4. Would this have been a reasonable classification because of the Commission's offer to permit us to request a separate order for depreciation as to each pole placed in Account 100.4? And yet there is no more reason for distinguishing between the "original cost" of and the balance paid for, acquired property than between red telephone poles and green telephone poles.

Finally, if we should accept the Commission at its word, submit to the Order as it now stands and then petition the Commission to allow us to depreciate tangible assets of these companies devoted to the public use, and we were then met with a ruling denying our petition, in accordance with certain recognized principles laid down by this Court, such a

ruling might well constitute a negative order not subject to court review.

Proctor and Gamble Company v. *U. S.*, 225 U. S. 282;
Lehigh Valley R. R. Co. v. *U. S.*, 243 U. S. 412;

See

Scharfman, The Interstate Commerce Commission, Vol. II, pages 406-417.

In other words, this proceeding may well be our last clear chance to obtain a judicial review of this ruling of the Commission as to depreciation.

The company cannot be denied the right to set up a depreciation reserve as to its investment in tangible property subject to depreciation in fact. It is elementary that provident management demands that a company shall preserve its property investment by taking out of its revenues each year an amount equivalent to the amount by which it is calculated to have depreciated and not been replaced by maintenance. This is the management's plain duty to its bondholders and stockholders who have supplied the funds for that investment. Its right to do this under the Constitution is fully sanctioned by judicial authority.

Knoxville v. *Knoxville Water Co.*, 212 U. S. 1, 13-14;
United Railways v. *West*, 280 U. S. 234, 253.

This principle has nothing to do with the computation of a rate base or the determination of fair and reasonable rates. Whether the full amount of the depreciation taken should be deducted in computing a fair return for the purpose of rate making is another question entirely. It may be that a provident management will require that the amount allowed as a fair return in a rate case shall be cut down by self imposed charges for depreciation not considered in such case. This it has a right to do. It has this right—yea,

duty—to protect the capital investment of its bondholders and stockholders. But this Order forbids the management to do this. What was paid for the tangible property subject to wear and tear is their capital investment in such property and to preserve this capital, depreciation reserves must be set aside out of revenues proportionate to that investment—not proportionate to someone else's investment. This principle has nothing to do with the rates. It does not affect rates, but it is vital to sound management and sound bookkeeping and the Commission cannot lawfully interfere with these.

The power to prescribe uniform forms of account does not include the power to interfere with the management of a company in the direction of its finances or to regulate the management of a company's finances. As was said by the New York Court in the case of *Matter of New York Edison Company* v. *Maltbie,* 244 App. Div. 685, at page 687 (aff'd 271 N. Y. 103):

> "The statute does not authorize the commission to prescribe uniform methods of management of the business of privately owned corporations. The uniformity that may be enforced is not as to what shall be done or how it shall be done, but as to book entries in respect to whatever is done."

In the case of *People ex rel. New York Railway Company* v. *Public Service Commission,* 223 N. Y. 373 the Court of Appeals said at page 378:

> "By establishing a system of accounts the corporations were required to show under particular heads what they had done. It was not to regulate the management of their finances but to show what the management was."

See also:

Passaic Consolidated Water Co. v. *Board of Public Utility Commissioners,* 5 N. J. M. 1078, 139 Atl. 324; aff'd 104 N. J. L. 666, 141 Atl. 921 (N. J. 1927);

Havre de Grace and Perryville Bridge Company v. *Towers,* 132 Md. 16, 103 Atl. 319, 321 (Md. 1918);

Southwestern Telephone Co. v. *Public Service Commission,* 262 U. S. 276, 289.

III.

The provisions of the order and system complained of are not severable and the order and system as a whole should be annulled and set aside and the enforcement thereof enjoined.

The System prescribed by the Commission purports to constitute a complete system of accounts and its various provisions are interlocking and supplementary to each other to a very large extent. With the elimination of the provisions complained of here and the provisions enjoined below it seems to us that this System is unworkable and a very extensive modification and revision would be necessary to constitute a practicable working system. Its invalidity as a whole must therefore be declared and its enforcement in its present form enjoined.

Respectfully submitted,

ALLEN T. KLOTS,

Solicitor for Additional Appellants.

HAYDEN N. SMITH,

G. SCHUYLER TARBELL, JR.,

Of Counsel.